DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0485
Income Tax
For Tax Years 2001-2003

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ISSUES

I. Income Tax—Consolidated Return**.**

Authority: *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992); *Indiana Department of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981); 15 U.S.C. § 381; I.R.C. § 382; I.R.C. § 936; IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-9; 45 IAC 3.1-1-38

Taxpayer protests the deconsolidation of companies from a consolidated return.

II. Tax Administration—Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is involved in manufacturing and distribution in Indiana and throughout the United States. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for gross income tax and supplemental net income tax for the tax years 2001 through 2002, and adjusted gross income tax for the tax years 2001 through 2003. Taxpayer filed a consolidated return including itself and three other companies each year, although the three companies were not the same every year. For 2001 and 2002, the consolidated return included two companies which were merged with Taxpayer in 2003, and were therefore not listed as separate entities on the 2003 return. Taxpayer also acquired two companies in 2003, which Taxpayer included on the consolidated return for 2003. Taxpayer protests the removal of one company from the consolidated return for 2001 and 2002, and the removal of one company from the consolidated return for 2003. Taxpayer also protests the disallowance of net operating losses associated with companies which were merged with Taxpayer during the audit period. Taxpayer also protests that a fifth related company involved in

consulting activities in Indiana should be included in the consolidated return. Taxpayer also protests the Department's adjustment of Taxpayer's I.R.C. § 936 related income. Further facts will be supplied as required.

I. Income Tax—Consolidated Return**.**

DISCUSSION

Taxpayer protests the Department's determination that two companies listed in Taxpayer's consolidated returns should not be included in that return. The deconsolidated companies had net operating losses which reduced the amount of tax due on the consolidated return. As a result of the Department's removal of those two companies, Taxpayer was unable to claim the net operating losses and the Department determined that additional income tax was due. Taxpayer believes that the two companies in question are eligible for inclusion in the consolidated return. The Department notes that, under IC § 6-8.1-5-1(c), the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made.

The relevant statute for consolidated returns is IC § 6-3-4-14, which states:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
>
> (b*) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.*
>
> (c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.
>
> (d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group. (*Emphasis added*.)

The Department determined that the two companies it removed from the consolidated return did not have adjusted gross income attributable to Indiana for the years in question. Therefore, as explained by IC § 6-3-4-14(b), without adjusted gross income derived from sources within the State of Indiana, those two companies cannot be included in the affiliated group filing a consolidated return.

Taxpayer protests that the two companies should be included in the consolidated return, and that they did have adjusted gross income attributable to sources within the State of Indiana. The adjusted gross income tax is imposed under IC § 6-3-2-2, which states in relevant part:

> a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
> In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.
> ….

45 IAC 3.1-1-38 provides:

> For apportionment purposes, a taxpayer is “doing business” in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title

> to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) *Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.*
> As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).
> (*Emphasis added.*)

Of relevance here is 15 U.S.C. 381 (Public Law 86-272), which prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales.

The Indiana Supreme Court explained in *Indiana Dept. of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981):

> Public Law 86-272 (*15 U.S.C.A. § 381*), in pertinent part is as follows:
>
> (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)--"
> *Id.*, at 1265.

The Court then explained:

> We also believe that Congress perceived "solicitation" as embodying "sundry activities so long as those activities [are] closely related to the eventual sale of a product." Finally, when a corporate representative performs an "act of courtesy" in order to accommodate a customer, he has not ventured beyond the realm of "solicitation."

Id., at 1268.

The United States Supreme Court explained its standard for determining “solicitation of sales” in *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992). In *Wrigley*, the Court explained:

> We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly *essential* to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are *entirely ancillary* to requests for purchases -- those that serve no independent business function apart from their connection to the soliciting of orders -- and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force. *National Tires, Inc. v. Lindley, 68 Ohio App. 2d 71, 78-79 426 N.E.2d 793, 798 (1980)* (company's activities went beyond solicitation to "functions more commonly related to maintaining an on-going business"). Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to *increase* purchases; but it is not ancillary to *requesting purchases*, and cannot be converted into "solicitation" by merely being assigned to salesmen. See, *e. g., Herff Jones Co. v. State Tax Comm'n, 247 Ore. 404, 412, 430 P.2d 998, 1001-1002 (1967)* (no § 381 immunity for sales representatives' collection activities).
> *Id.*, at 228-30.

The Court further explained:

> By contrast, Wrigley's in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which Wrigley's regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [Wrigley's] credit department communicating." App. 71, 72. It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee -- some company ombudsman, so to speak -- if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases.
>
> Finally, Wrigley argues that the various nonimmune activities, considered singly or together, are *de minimis*. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007[percent] of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred

> dollars a year. We need not decide whether any of the nonimmune activities was *de minimis* in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose, as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.
> *Id.*, at 234-5.

Therefore, the Department may look at a taxpayer's Indiana activities as a whole to determine if the activities as a whole exceed the protection of Public Law 86-272.

In the instant case, Taxpayer has provided documentation establishing that employees of the two companies in question performed activities which went beyond the protection of Public Law 86-272. As explained in *Wrigley*, a taxpayer's activities are examined as a whole and if a taxpayer has non-protected activities in a state which are not trivial, that taxpayer is not protected by Public Law 86-272. Here, both companies had significant Indiana-based employee payrolls, including many employees who were not engaged in sales-related activities. Also, one company rented office space in Indiana, which is defined as doing business in Indiana by 45 IAC 3.1-1-38(5). The other company owned over one million dollars worth of manufacturing machinery in Indiana, which is defined as doing business in Indiana by 45 IAC 3.1-1-38(5). When reviewed as a whole, and considering that the companies did conduct non-protected activities in Indiana, the two companies were subject to Indiana adjusted gross income tax, as provided by *Wrigley*.

The Department removed the two companies in question due to the determination that the two companies did not have adjusted gross income derived from Indiana sources. It has now been established that the two companies did have adjusted gross income which would subject them to Indiana adjusted gross income tax. Therefore, the two companies should be included on the consolidated return.

Next, Taxpayer protests that a third company, which was not originally included on the consolidated return, should be included in the consolidated return. The Department determined that there was insufficient documentation to support including that company in the consolidated return. Taxpayer has since provided additional documentation establishing that the company, while primarily providing services from an out-of-state location, did have employees come into Indiana to provide training and technical assistance. As previously explained, *Wrigley* provides that a taxpayer's activities as a whole are examined to determine if the activities are not de minimis. As with the two deconsolidated companies, the third company's activities, when reviewed as a whole, are not de minimis. The activities rise to the level which subjects the company to Indiana adjusted gross income tax, and therefore make the company eligible for inclusion in the consolidated return.

Next, Taxpayer protests the determination to disallow net operating losses from the deconsolidated companies. Since it has been determined that the two companies should be in the consolidated return, it must be determined if the net operating losses are allowed to be retained and used after a merger. The relevant regulation is 45 IAC 3.1-1-9, which states in relevant part:

> When a corporate merger takes place or a new subsidiary is included in a consolidated Indiana Adjusted Gross Income Tax return, the Department follows the guidelines of the Internal Revenue Code as to the treatment of net operating losses sustained by any of the corporations involved.

The Internal Revenue Code (I.R.C.) § 382(g), explains that net operating losses are partially or totally limited if taxpayer experiences an increase of fifty percent of the aggregate shares owned by shareholders owning five or more percent of the corporation over a three-year period. In the merger at issue, Taxpayer's ownership did not change. Two corporations with common ownership merged. As a result, the taxpayer was able, under I.R.C. § 382(g), to carry forward the net operating losses of its predecessor. Therefore, under 45 IAC 3.1-1-9, Taxpayer is able to carryover the net operating losses.

Next, Taxpayer protests the Department's adjustment to Taxpayer's I.R.C. § 936 income. This section allows a federal tax credit against income generated from qualified investments in Puerto Rico. One of the requirements of I.R.C. § 936(h)(5) is that the costs of research and development must be paid back to the affiliated group. This research and development payment is treated as income for federal purposes. The Department determined that Taxpayer should have reported this income on line ten of its federal form 1120, but did not do so. Taxpayer protests that the income is reported on various other lines of form 1120, and that the Department did not deduct those entries before adding the income to line ten.

Previously, Taxpayer asked for and received an advisory letter from the Department regarding how to apply the I.R.C. § 936 credit. The advisory letter does state that the Internal Revenue Service (IRS) requires that the net income recognized under the Profit Split Method (PSM) be reported on line ten, as explained in the audit report. The advisory letter also states that receipts and expenses associated with the goods manufactured by the subsidiary should not be reflected elsewhere on form 1120. Taxpayer protests that the IRS has examined Taxpayer's returns and has not made any adjustments to the reporting or computation method for I.R.C. § 936 credit purposes. Taxpayer has provided documentation supporting this argument.

The Department added the income it believed should have been reported on line ten of federal form 1120 to Taxpayer's reported federal income, and then recalculated Indiana income using the new federal amounts. The Department explained that, because Indiana taxable income begins with federal taxable income, any change to federal taxable income results in a change in Indiana taxable income. The IRS examines Taxpayer's returns and reporting methods for federal income purposes. Taxpayer has established that the IRS has examined Taxpayer's returns and reporting method and has not made any changes to its federal taxable income regarding I.R.C. § 936. Since the IRS has not informed the Department of any changes to Taxpayer's federal taxable income regarding I.R.C. § 936 for the tax years at issue, there should be no changes to

Taxpayer's federal income for those years based on the Department's adjustments regarding I.R.C. § 936.

In conclusion, the two companies which the Department deconsolidated due to lack of Indiana-sourced adjusted gross income, did have Indiana-sourced adjusted gross income, and were properly included in the consolidated return. There is now sufficient documentation to establish that the company which was not originally included in the consolidated return also had Indiana-sourced adjusted gross income and should be included in the consolidated return. Since the ownership did not change, the net operating losses of the companies which were merged into Taxpayer were available after the merger, thereby satisfying the federal requirements for net operating loss carryover. Taxpayer has established that the method of reporting income relating to I.R.C. § 936 has not been changed at the federal level, thereby making adjustments at the Indiana level unnecessary.

FINDING

Taxpayer's protest is sustained. The two companies which were deconsolidated will remain consolidated. The third company will be included on the consolidated return. The net operating losses were available after the merger. The I.R.C. § 936 figures were correct as reported on the federal returns.

II. **Tax Administration**—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence.

> Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer did not incur a deficiency due to negligence under 45 IAC 15-11-2(b), and so was not subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer has affirmatively established that there was no failure to pay a deficiency, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

WL/BK/DK September 11, 2007.